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IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

MILLINERY CENTER BUILDING CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

Petitioner prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Second Circuit, entered in the above-entitled case on May 18, 1955.

Citations to Opinions Below:

The opinion of the Tax Court of the United States (R. 12-20) printed in Appendix "A" hereto, infra (p. 20-28) is reported in 21 T. C. 817. The opinion of the United States Court of Appeals for the Second Circuit, (R. 31-35) rendered on April 14, 1955, printed in Appendix "A" hereto, infra (p. 31-35) has not yet been officially reported.

NOTE: Unless otherwise indicated, numerical references in parenthesis preceded by letter "R" are to certified Record of Court of Appeals.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered on May 18, 1955 (R. 51). A timely petition for rehearing, printed in Appendix "A" hereto (p. 37-46) was denied on May 18, 1955 (R. 50-52) (p. 49). The jurisdiction of this court is invoked under 28 U. S. Code, Section 1254(1).

Questions Presented

1. Where a lessee, the owner of a valuable building on leased land, acquires the fee to the land to be relieved of what it considers to be the burdensome terms of a lease, may the lessee deduct the excess of the payment over the determined value of the land at the date of purchase as an ordinary expense of doing business under Section 23(a) of the United States Internal Revenue Code of 1939 or under section 23(f) as a loss on a transaction entered into for profit and not compensated for by insurance or otherwise.

2. In the alternative, may the lessee-petitioner consider the excess payment over the determined value of the land to be in the nature of a prepayment of rent for the remaining term of the extinguished lease and amortize such amount over 21 years?

3. In the further alternative, is the lessee-petitioner entitled to depreciate the payment in excess of the determined value of the land over the remaining economic life of the building under Section 23(l) of the United States Internal Revenue Code of 1939?

Statutes Involved

Pertinent provisions of the United States Internal Revenue Code of 1939, adopted by Act of February 10, 1939, Ch. 2, 53 Stat. 1504, applicable to this proceeding are:

"Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.

(1) Trade or business expenses.

(a) In general. All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *"

"Sec. 23. (f) Losses by Corporations.

In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise. * * *"

"Sec. 23. (l) Depreciation.

A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income. * * *"

"Sec. 272. Procedure in General.

(a) (1) Petition to the Tax Court of the United States.

If in the case of any taxpayer, the Commissioner determines that there is a deficiency in respect of the tax imposed by this chapter, the Commissioner is authorized to send notice of such deficiency to the taxpayer by registered mail. Within ninety days after such notice is mailed (not counting Saturday, Sunday or a legal holiday in the District of Columbia as the ninetieth day) the taxpayer may file a petition with the Tax Court of the United States for a redetermination of the deficiency. * * *"

Statement

The petitioner duly filed its petition for a redetermination of its excess profits tax liability for the calendar year 1945 with the Tax Court of the United States, which had jurisdiction over the proceeding in the first instance, in accordance with Section 272(a) of the United States Internal Revenue Code of 1939.

The Tax Court of the United States rendered its opinion on February 26, 1954, and entered its decision on March 22, 1954, on the basis of the pleadings, oral testimony, arguments and briefs. (Appendix "A"—R. 12-21) (p. 20-29)

It was determined by the Tax Court of the United States that the lessee petitioner (the owner of the building) was not entitled to deduct any part of a payment made by it to the owner of the land over and above the value of the land at the date of purchase of such land to obtain a cancellation of an onerous lease; that the payment made by the petitioner was for a "bundle of rights", no part of which was amortizable over the remaining term of the extinguished lease or depreciable over the remaining economic life of the building. (Appendix "A" R. 12-19) (p. 20-28)

The Tax Court was sustained by the United States Court of Appeals for the Second Circuit in its holding that the excess payment over the value of the land was a capital asset and could not be deducted as an expense or a loss or that any part of the payment to the owner of the property was amortizable (Appendix "A" R. 32-33) (p. 32-34) but agreed with the six dissenting judges of the Tax Court of the United States that the petitioner had additional building costs resulting from the purchase of the fee and was entitled to depreciation on the amount attributable to the building. (Appendix "A" R. 34) p. 34-35.

The judgment of the United States Circuit Court of Appeals was entered on May 18, 1955, reversing the Tax Court of the United States with respect to the right of the petitioner to be allowed depreciation on additional cost of building acquired by purchase. (Appendix "A" R. 35 p. 35)

Reasons for Granting the Writ

I.

The decision of the court below in the instant case is in direct conflict with the decision of the United States Court of Appeals for the Sixth Circuit in the case of *Cleveland-Allerton Hotel, Inc.* v. *Commissioner of Internal Revenue*, 166 F. 2d 805, set out in Appendix "B" hereto. (p. 51-56) Indeed, both the Tax Court and the United States Court of Appeals for the Second Circuit, in their opinions, Appendix "A" (R. 15, 32) p. 24, 32, noted the decision of the United States Court of Appeals for the Sixth Circuit but refused to follow the principles set forth in that decision. The factual situations in the instant case and in the *Cleveland-Allerton Hotel, Inc., supra*, are quite similar and the principles of law are identical.

In both cases, the lessee built a substantial building on land owned by the lessor, in the instant case, a 22-story

loft building on Seventh Avenue and 38th Street, New York City, at a cost of $3,000,000; whereas in the *Cleveland-Allerton Hotel* case, the hotel was built in the City of Cleveland by the lessee at a cost in excess of $267,000. In the instant case, the tenant had a lease for 21 years with an option to renew the lease for two successive terms of 21 years each, whereas in the *Cleveland-Allerton Hotel* case, the term was for 99 years and renewable in perpetuity. In each case the building was the property of the tenant for its useful economic life and in each case the lessee had the right to the use, rents and profits of the land for the term of the lease, subject to the obligation to surrender it at the end of the term, with this difference, that the lessee-petitioner in the instant case might be required to tear down the building at its own cost if the lessor refused to accept title to the building at the termination of the lease. (Appendix "A" R. 8, 32, pp. 16, 32) In each case the lessee sought to obtain relief from the onerous terms of the lease; in the present case, the tenant, at the time of renewal of its lease, found that the rental it was paying for the property was excessive to the extent of more than $78,000 per annum, whereas in the case of the Cleveland-Allerton Hotel, Inc., the rental it was paying annually was $15,000 over the fair rental value of the land. In neither case was a separate consideration stated for the value of the cancelled leasehold interest in the contract of sale. In each case the contract of sale required that the landlord cancel the lease and the lessee be discharged from the terms of the lease. (Appendix "A", R. 9, pp. 17, 53, 54)

The United States Court of Appeals for the Sixth Circuit determined that the excess price paid for the land over its fair market value without the lease represented an allowable deduction as an expense of doing business, in accordance with Section 23(a) of the Internal Revenue Code of

1939 to escape from a burdensome lease. (Appendix "B", p. 55)

The United States Court of Appeals for the Second Circuit does not subscribe to the views expressed by the United States Court of Appeals for the Sixth Circuit and considers the whole consideration paid as a capital item. (Appendix "A", R. 32, 33, p. 33)

In each case the lessee-petitioner claimed in the alternative that the excessive amount paid over the value of the land at the date of purchase should be written off over the term of the lease or over the remaining economic life of the building. (Appendix "A", R. 12, p. 20; Appendix "B", p. 53)

The United States Court of Appeals for the Sixth Circuit, having determined the excessive amount paid for the land was deductible in full in the year of purchase of fee and the discharge of the lease as an ordinary and necessary expense under Section 23(a) of the United States Internal Revenue Code of 1939, did not have to pass on the alternative claims. (Appendix "B", p. 56)

The United States Court of Appeals for the Second Circuit determined that no part of the excessive amount was amortizable though it found that the petitioner's second alternative claim for depreciation of building should be allowed. (Appendix "A", R. 34, p. 34)

II.

Clearly the difference in legal principles derived from the same set of facts by two different United States Circuit Courts of Appeal requires that this Court grant certiorari to settle the question. Petitioner's attorneys are advised that a great many cases are pending in the various Circuits where the same question is involved. Most certainly the question presented is of great importance to the

administration of the Federal tax statutes and attorneys are entitled to have the law settled so as to properly advise their clients.

III.

The decision of the Court of Appeals in this proceeding is believed to be clearly wrong in its failure to allow as an ordinary expense of doing business the full amount of the excess payment incurred to be relieved of a burdensome lease. The decision of the United States Court of Appeals for the Sixth Circuit in the *Cleveland-Allerton Hotel, Inc., supra,* is clearly correct.

Support for the principle expressed therein by the United States Court of Appeals for the Sixth Circuit may be found in the decision of the United States Court of Appeals for the Ninth Circuit in *Stuart* v. *Commissioner of Internal Revenue,* 195 F. 2d. 176 (1952). Deductions of amounts paid by a tenant to obtain the cancellation of a lease were allowed in the cases of *Cassatt* v. *Commissioner,* 137 F. 2d. 745 (3rd CAA) 1943; *Denholm & McKay* v. *Commissioner,* 2 B. T. A. 444.

The incurring of an expense to reduce the total cost of operating a trade or business is so obviously allowable it is unnecessary to quote authority for its deductibility. By making the payment of $2,100,000 to the lessor of the property for the value of land determined by the Tax Court of the United States, on the basis of competent authority, to be worth only $660,000, the petitioner paid $1,440,000 to be relieved of the onerous terms of the lease under which it was required to pay the sum of $2,495,640 in rentals over the next 21 years, whereas the fair rental value of the land over the next 21 years was only $840,000, according to undisputed authoritative evidence produced before the Tax Court of the United States.

IV.

The taxpayer claims alternatively that if the $1,440,000 ($2,100,000 less $660,000 value of land) is not allowable as a deduction in full in the year 1945; then this amount is in the nature of prepaid rent and the petitioner is entitled to amortize said amount over the period benefited, i.e. 21 years. Since the fair rental value of the land for the next 21 years did not exceed $840,000 (21 x $40,000) that part of petitioner's payment in excess of the determined value of the land, or $1,440,000, was for all practical purposes payment for the balance of the rent of $1,655,640 for the next 21 years.

V.

To illustrate one instance that prepayment of expenses may be written off over the period benefitted, the attention of this Honorable Court is directed to the case of *Laird Bell* v. *Harrison*, 212 F. 2d 253, decided by the United States Court of Appeals for the Seventh Circuit (4/27/1954). In that case a trust remainderman purchased the life interest of his parents, amortizing the cost of the life estates over the life expectancy of his parents. The Circuit Court dismissed the Commissioner's contention of merger of life estate and remainder estate and considered the amount paid to be prepayment for income to be received, which prepayment, being a wasting asset, was recoverable over the period that the taxpayer would benefit.

VI.

In the further alternative, taxpayer claims that if the excess payment to the lessor over the value of the land is not allowable as a deduction in full in 1945 or amortizable over the 21-year period benefitted, then such excess represents additional building cost depreciable over the agreed 30-year remaining economic life of the building.

VII.

Though title to the building was nominally in the petitioner, actual ownership for all practical purposes was in the lessor. Petitioner's right to the use, rents and profits of the building flowed from the lease and not from title ownership. Under the terms of the lease, even the nominal title to the building passed to the lessor upon termination of the lease (Appendix "A", R. 7, p. 16). Under the agreement of June 11, 1945, the lease was cancelled simultaneously with the purchase of the fee (Appendix "A", R. 8, 9, p. 16, 17). Therefore the petitioner acquired immediate title to the land and the building and not merely a reversionary interest in the building.

In accordance with Section 23(l) of the United States Revenue Code of 1939, petitioner is entitled to recover the value ascribed to the building at the date of purchase over the agreed remaining economic life of 30 years.

Conclusion.

For the foregoing reasons, this petition for writ of certiorari should be granted.

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APPENDIX A

Findings of Fact and Opinions.

[233]

21 T. C. No. 92

THE TAX COURT OF THE UNITED STATES

MILLINERY CENTER BUILDING CORP. (now Fashion Center Building Corp.),

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 36321. Promulgated February 26, 1954.

1. Petitioner purchased land which it had under lease for a period of 21 years for a consideration of $2,100,000. The fair market value of the land was $660,000, if it had been unimproved on the date of purchase. Petitioner claims that the remaining $1,440,000 was paid to secure the cancellation of a burdensome lease which had 21 years to run. Petitioner claims deduction of the $1,440,000 which, it maintains, should be allocated to the cost of canceling the lease as an ordinary and necessary business expense under section 23(a) of the Code. *Held*, the $1,440,000 is not deductible in the year paid as an ordinary and necessary business expense. *Cleveland Allerton Hotel, Inc.* v. *Commissioner*, 166 F. 2d 805, reversing T. C. Memorandum Opinion, not followed.

[234] (2) In the alternative, petitioner claims that it should be permitted to amortize over the remaining term

of the lease all that it paid in excess of the value of the land, if it had been unimproved at the time of purchase as the cost of canceling a burdensome lease. *Held*, that petitioner, in procuring the cancellation of its lease as a part of the transaction in acquiring the land, did not acquire a capital asset in the cancellation of its lease and has no legal ground for the amortization deduction which it claims under its first alternative.

(3) In its second alternative, petitioner claims that all that it paid in excess of the fair market value of the land in an unimproved condition should be allocated as additional cost of its building and that it should be allowed depreciation based on this additional cost spread over the remaining useful life of the building. *Held*, that petitioner already owned the building and had been permitted to recover by way of depreciation, including the amount of depreciation allowed by the Commissioner in the taxable year, the full amount of the cost of its building and has no unrecovered cost which it is entitled to recover by way of depreciation. It has no additional cost of its building by reason of the transactions here.

[235] 4. In the taxable year petitioner incurred and paid $16,500 attorneys fees in acquiring title to the land and cancellation of the lease. The Commissioner disallowed petitioner the deduction of said amount on the ground that it was a capital expense. *Held*, the expenditure was made in the acquiring of capital assets and is not deductible.

Bernard Weiss, Esq., and Sidney Gelfand, Esq., for the petitioner.

John J. Madden, Esq., for the respondent.

The Commissioner has determined a deficiency in petitioner's excess profits tax for the year 1945 of $39,465.62. The deficiency is due to five adjustments made by the Commissioner to the income as reported by petitioner on its return. These adjustments were:

(a) Capital Stock Tax.	$ 5,000.00
(b) Legal Expense	16,500.00
(c) Prepaid Rent	8.33
(d) Depreciation	15,679.32
(e) Net short term capital gain	1,899.38
Total	$39,087.03

Adjustment (b) is explained in the deficiency notice as follows:

> (b) Deduction of legal expenses, in the amount of $16,500.00, incurred in connection with the acquisition of your property has been disallowed because it represents a capital expense.

Adjustment (d) is explained in the deficiency notice as follows:

> (d) A reasonable allowance for the depreciation of your building and improvements is determined to be $65,330.57, rather than the amount of $81,009.89 deducted in your return.
>
> No allowance has been made with respect to a payment by you to allegedly obtain the cancellation of a lease, in the absence of information showing that a deductible business expense was incurred.

In its original petition petitioner made two assignments of error:

> a) The Commissioner of Internal Revenue has failed to allow as a deduction an ordinary and neces-

sary business expense in the amount of $1,600,000.00 incurred to secure a release from a 21 year lease with a minimum rental of approximately $225,000.00 per annum.

[236] b) Alternatively to sub-paragraph (a) above, petitioner contends the Commissioner of Internal Revenue has failed to allow an additional deduction for depreciation in the amount of $35,961.60.

At the hearing petitioner filed an amended petition changing paragraph (b) above and adding (c) and (d), as follows:

(b) Alternatively to sub-paragraph (a) above, petitioner contends the amount paid in excess of the value of the land, namely $1,500,000., should be amortized over a period of 21 years. Commissioner of Internal Revenue has failed to allow a deduction for such amortization.

(c) In the further alternatives to sub-paragraphs (a) and (b) above, Commissioner of Internal Revenue has failed to allow an additional deduction for depreciation in the amount of $36,000.00.

(d) Commissioner of Internal Revenue has failed to allow as a deduction that part of the legal expense in the amount of $16,500.00 and sundry expense in the amount of $4,552.50 incurred in connection with obtaining a release by the petitioner from its lease agreement with the landlord.

The respondent's other adjustments are not contested.

Some of the facts have been stipulated and are found accordingly.

Petitioner is a corporation with its principal office in New York City. The returns for the period involved here were filed with the collector for the third district of New York.

On April 30, 1924, petitioner leased land located at the northeast corner of Seventh Avenue and 38th Street, New York City. The size of the plot is 98 feet 9 inches on the east side of Seventh Avenue and 200 feet on 38th Street. The lease provided for an annual net basic rental of $100,000, plus the income taxes that would be incurred by the lessor upon the receipt of the $100,000 per annum. The lease between petitioner and the landlord [237] was amended on November 30, 1935, to provide for an annual net rental of $118,840 without petitioner being liable for reimbursing the landlord for any income tax thereon. On April 16, 1945, petitioner exercised the option contained in the lease agreement to extend the lease for a period of 21 years to April 30, 1966.

In accordance with the terms of the lease, the petitioner-tenant erected a 22-story loft building at a cost of $3,000,000, including taxes, interest and insurance during construction on the leased land. Title to the building, improvements and fixtures belonged to the tenant-petitioner. Title to this property was to vest in the landlord at the expiration of the last term of the lease only at the option of the landlord. In the event of the destruction of the building by fire or other causes, the petitioner-tenant was still liable on the lease and could not abandon the lease. In the event of the destruction, in whole or in part, of the building petitioner-tenant at its own cost had to make the

building whole. At the expiration of the lease or any renewal period, petitioner-tenant was to surrender the premises and the building to the landlord at his option, free and clear of all encumbrances, without the landlord being obligated to pay for such property. Petitioner-tenant had the option to renew the lease for two successive 21-year periods. The ground rent for the renewal period was to be six per cent of the value of the land at the termination of each period of the lease but not to be less than the basic rent of $100,000, plus the additional rent of $18,840. The value of the land was to be determined as if vacant and unimproved. The rent at six per cent of the value of the land in May 1945, would have been less than the minimum basic rental of $100,000.

[238] On May 11, 1945, petitioner entered into an agreement of sale with Wendel Foundation, the owner of the land. Title to the land was taken by petitioner on June 11, 1945. Petitioner purchased the fee and obtained release from the obligations of the renewed lease for $2,100,000. Petitioner purchased the fee to be released from the terms of the lease. Petitioner was most concerned about the annual rental of $118,840, which it deemed excessive, and the contingent liability to remove the building from the premises at the expiration of the lease upon the request of the landlord. The agreement of sale between Wendel Foundation, the lessor and owner of the fee, and petitioner contained, among other provisions, the following:

> WITNESSETH that the Seller agrees to sell and convey and the Purchaser agrees to purchase:
>
> [Here follows a description of the premises.]
>
> The price is Two Million One Hundred Thousand Dollars ($2,100,000) payable as follows: Two Hun-

dred Ten Thousand Dollars ($210,000) on the signing of this contract, receipt whereof by check subject to collection is hereby acknowledged, the non-payment of which check in due course shall give Seller the option of cancelling this agreement; and the balance, One Million Eight Hundred Ninety Thousand Dollars ($1,890,000) on the delivery of the deed as hereinafter provided, by certified check satisfactory to the Seller, the check to be drawn to the order of the Seller and payable through the New York Clearing House.

* * * * *

Seller shall execute upon request of Purchaser an agreement cancelling and terminating said lease as of the time of the actual closing of title hereunder. It is agreed however that regardless of whether Purchaser accepts title to the premises subject to the aforementioned lease or elects to have an agreement cancelling and terminating same, the idemnity [sic] agreements of Purchaser contained in the said lease shall continue in full force and effect after closing of title in favor of the Seller with respect to any liabilities or obligations of Seller assumed by or imposed upon it by the terms of the lease or any such agreements of amendment, modification, extension or renewal or arising out of Seller's ownership of the said premises.

* * * * *

[239] The deed shall be in proper statutory short form for record in the usual form of a Bargain and Sale deed containing no covenant or warranty and shall be duly executed and acknowledged by Seller at Seller's expense, * * *

The agreement of cancellation of the lease was executed June 11, 1945, and contains, among other things, the following language:

> WHEREAS, the Tenant requested the Landlord to accept a surrender of the demised term and the Landlord agreed to accept such surrender provided this agreement was executed simultaneously with the execution of the formal agreement of surrender, which formal agreement of surrender is being executed and delivered simultaneously herewith:
>
> NOW, THEREFORE, in consideration of the premises and the sum of One Dollar ($1.00) and other good and valuable consideration by each of the parties hereto to the other in hand paid, receipt whereof is hereby acknowledged, the parties hereto do hereby mutually release one another and their successors and assigns from any and all obligations under said lease and modification agreement and under said agreement of renewal and extension thereof, * * *

The land purchased by petitioner contained 19,750 square feet and was located in Block No. 814, bounded by 38th Street, Seventh Avenue, 39th Street, and Broadway. The Millinery Center Building and the land on which it stood, were assessed for real estate tax purposes as follows:

	Land	*Building*	*Total*
1943-1944	$1,470,000	$2,305,000	$3,775,000
1944-1945	1,410,000	2,165,000	3,575,000

The remainder of Block No. 814, comprising 45,178 square feet and improvements thereon, was sold on De-

cember 2, 1943, for $1,250,000. This property had a frontage of 205 feet on the west side of Broadway, 301 feet on 39th Street, 165 feet on 38th Street, and 98 feet and 9 inches on Seventh Avenue, and was assessed for real estate tax purposes as follows:

[240]

	Land	*Building*	*Total*
1943-1944	$3,830,000	$ 115,000	$3,945,000
1944-1945	3,735,000	100,000	3,835,000

Lot 64 of Block No. 813 on the southeast corner of 38th Street and Seventh Avenue had the same frontage with identical dimensions as the property in question and was located directly across the street. Lot 64 was offered for sale in 1945 for an amount less than $600,000 but remained unsold. That lot with improvements was previously sold on March 1, 1944, for $600,000. This property was assessed for real estate tax purposes as follows:

	Land	*Building*	*Total*
1943-1944, and 1944-1945	$1,225,000	$35,000	$1,260,000

Lot 55, Block No. 813 was leased in December 1924 by the landlord for a net basic rental of $115,000, plus the income taxes thereon, for a term of 21 years with two renewal options of 21 years each. The rental was changed to $138,000 in lieu of $115,000, plus the income tax thereon. Pursuant to the terms of the lease, the lessees had erected a 23-story building which was completed in 1926. The lease was renewed on April 26, 1945. On May 8, 1945, the fee to the land, on which was the building erected by the tenant and subject to a long-term lease, was sold to the Woodmen of the World for $2,250,000.

In 1945, the United States Government restrictions on building construction plus the restrictions contained in New York State rent laws adversely affected the value of land. Limitations Order L-41 restricting building construction became effective in 1942 and was still in effect through the year 1945.

[241] The value of the land, vacant and unimproved, upon which the petitioner's property stood was $660,000 when purchased by petitioner in 1945.

Petitioner incurred legal fees aggregating $16,500 in connection with the purchase of the fee and the release from the obligations under its lease with the Wendel Foundation.

Opinion.

BLACK, *Judge*: Petitioner states the issues raised by the pleadings, in its brief, as follows:

I.

Is the petitioner entitled to deduct the amount of $1,500,000 or any part thereof incurred in connection with the cancellation of a burdensome lease as an ordinary and necessary expense under Section 23(a) or as a loss under Section 23(f) of the Internal Revenue Code? Or, in the alternative, is the petitioner entitled to amortize the said $1,500,000 or any part thereof incurred in obtaining a release from the burdesome 21 year lease over the remaining term of such lease?

II.

In the further alternative, is the petitioner entitled to capitalize that part of the price paid of

$2,100,000 over and above the actual land value as the purchase price of the building and depreciate said cost of building over the remaining building life of 30 years?

III.

Is petitioner entitled to deduct that part of the $16,500.00 legal expenses incurred to acquire the fee and to cancel a burdensome lease that is applicable to the cancellation of the burdensome lease?

The principal issue in this proceeding is whether petitioner, a lessee in possession who purchases the fee and the cancellation of the lease for a price greater than the value of the land, may allocate a portion of the purchase [242] price to the purchase of the lease and deduct the allocated portion as a business expense under section 23(a). Respondent in his deficiency notice determined that "No allowance has been made with respect to a payment by you to allegedly obtain the cancellation of a lease, in the absence of information showing that a deductible business expense was incurred." Respondent still contends that no part of the purchase price of $2,100,000 paid by petitioner in 1945 to the Wendel Foundation can be deducted as a business expense nor is petitioner entitled to use any part of this purchase price as a basis for amortization or depreciation deductions. For reasons which we will presently give, we think respondent must be sustained in each of these contentions.

Business Expense.

Petitioner paid $2,100,000 under the agreement of May 11, 1945, to the Wendel Foundation. Credible and uncontradicted testimony placed the value of the land at $600,000.

if it had been in an unimproved condition at the time of purchase. But it must be remembered that petitioner did not purchase the land in an unimproved condition. The land, when petitioner purchased it in 1945, was improved by a building which had been erected by petitioner in a prior year at a cost of $3,000,000, and the land was leased to petitioner for a term of 21 years still to run at an annual rental of $118,840. What petitioner paid Wendel Foundation $2,100,000 for was the bundle of rights which it obtained in the purchase. Included in this bundle of rights was the cancellation of the lease which still had 21 years more to run. Petitioner contends that all above $660,000, which was the value of the land if it had been in an unimproved condition, or $1,440,000, represented the price which it paid for the cancellation of its lease and that [243] this entire amount of $1,440,000 should be allowed in the taxable year 1945 as a deductible business expense under section 23(a) of the Code printed in the margin.[1] Petitioner, in contending that the entire amount of $1,440,000 should be allowed as a deduction for business expense in the

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[1] SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or business expenses.—

(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

taxable year, relies heavily upon *Cleveland Allerton Hotel, Inc. v. Commissioner*, [195] F. 2d 803, reversing T. C. Memorandum Opinion. In that case the court of appeals said:

> As purely legalistic formalism, this argumentation bears an aura of validity. Realistically considered, however, it will not stand analysis. The status of the petitioner does not approximate that of a third person investor, buying real estate to which is appurtenant a long-term profitable lease. The petitioner already had the use of the land with full control and dominion over it, subject only to its obligation to surrender it at the end of the term. The lease was a liability which it sought to extinguish. This it was impossible to do merely by buying acquittance and giving up possesion of the premises. It had thereupon a valuable hotel building which it could not take away with it. The only interest in the land it secured by the purchase that it did not already have was the reversionary interest, which all parties appear to consider as of only nominal value. To consider that remainder a capital asset with a value of $441,250 requires, [244] it seems to us, a naivete not attributable to experienced and sophisticated taxing authority. * * *
>
> If numerous admonitions that taxation is a practical matter, that taxing authority may look through form to substance, is not mere rhetoric where the taxpayer's interests is involved, and a working formula only when it is of advantage to the Treasury, it would seem to be clear that the petitioner paid all over $200,000 to escape from a burdensome lease, and should be able to write that off as an expense of doing business.

We are unable to agree with the learned court that in a case like the *Cleveland Allerton Hotel* case or the one which we have here, the taxpayer should be allowed to deduct as a business expense in the year when paid that part of its payment which it claims should be allocated to the cancellation of a burdensome lease. The court in holding that the amount which the taxpayer claimed should be allocated to the cancellation of the burdensome lease and should be allowed as a deductible business expense in one year said:

> This being so, we find ourselves in accord with the decision of the Third Circuit in Cassatt v. Commissioner, 3 Cir., 137 F. 2d 745 and with the decision of the Board of Tax Appeals in Appeal of Denholm & McKay Co., 2 B. T. A. 444, that payments of this character must be deducted on the taxpayer's tax return as an expense of doing business in the year when made. * * *

We think *Cassatt* v. *Commissioner*, 137 F. 2d 745, affirming 47 B. T. A. 400, and *Denholm & McKay Co.*, 2 B. T. A. 444, are distinguishable. In *Denholm & McKay Co.*, the taxpayer did not own the building which it was renting. Both building and land were owned by the Denholm & McKay Realty Co. and what the taxpayer purchased from the Realty Co. was a complete cancellation of the lease and a surrender of possession under that particular lease and the securing of a new lease of the same building under much more favorable terms than the old lease. Denholm & McKay did not acquire title to the land from the Realty Co. In *Cassatt* v. *Commissioner*, *supra*, the court pointed out that:

> [245] In the early part of January, 1935, Cassatt and Company were obligated on several leases of office

> space for terms not expiring until 1941. The aggregate prospective rentals for these leases was $1,076,000. A settlement was effected with the various landlords whereby for $340,524.00 the leases were cancelled for the unexpired terms. * * *

Thus, in that case there was not only a cancellation of the leases but a complete surrender of possession thereunder to the landlords.

We have no such case here. As we have already pointed out, petitioner, in making purchase of the cancellation of the lease from Wendel Foundation, had no notion of surrendering possession to the landlord. If it had done so, we would, of course, have an entirely different case from the one we have here. It owned a 22-story steel and concrete building which, according to testimony, had a remaining useful life of 30 years. What petitioner purchased for $2,100,000 is shown in its contract of purchase dated May 11, 1945, followed by the deed to the property which petitioner received on June 11, 1945. Petitioner purchased a capital asset and we sustain the Commissioner in his determination that no part of the purchase price can be deducted as a business expense in 1945. Cf. *Home Trust Co.* v. *Commissioner*, 65 F. 2d 532.

Claim for Amortization Deduction.

Petitioner's first alternative is stated thus in its brief:

> However, in the event the Court should find that the amount paid in excess of the land value to effect a saving in rent expense is a capital asset, petitioner then claims it is entitled to amortize said asset over 21 years, the remaining life of the cancelled lease.

[246] Petitioner does not cite any authority in support of this first alternative contention and we do not know of

any. It is, of course, true that if a taxpayer purchases a lease which has, say 21 years to run, and does not purchase the fee his purchase is a wasting asset and the cost of the lease is not deductible in the year of purchase but must be amortized over the life of the lease. See *Home Trust Co. v. Commissioner, supra,* and many cases there cited. But here petitioner has not purchased any lease. In the transaction which has been consummated petitioner has obtained title to the land and has secured the cancellation of the lease which, under the circumstances then existing, it regarded as burdensome. It is true, of course, that petitioner in the purchase of land acquired a capital asset but it is not an asset which is subject to depreciation or amortization. Its value may increase from year to year or, on the other hand, may decrease but gain or loss can be taken only when the land is finally disposed of. But, while it is true that petitioner in the purchase of the land in 1945 acquired a capital asset, we do not think it can be said that petitioner in procuring the cancellation of its burdensome lease acquired a capital asset which it can amortize over the remaining term of the lease. The lease was at an end when petitioner procured its cancellation in 1945. We think petitioner's first alternative contention must be denied.

Additional Depreciation on the Building.

Petitioner's second alternative is stated in its brief as follows:

> In the event the Court should find that no part of the payment of $2,100,000 represents an allowable deduction for obtaining a release from a lease agreement, petitioner then contends that $1,500,000 represents the cost of building which it is entitled to depreciate over a remaining life of 30 years.

[247] The following fact with reference to depreciation seem to be undisputed by the parties: The respondent, for the taxable year, has allowed petitioner depreciation on the building equivalent to petitioner's unrecovered cost because its first 21-year term of the lease ended in 1945. That depreciation deduction is not in dispute here. During this original 21-year term of the lease, including the part of it which expired in 1945, petitioner has recovered tax free through depreciation deductions the entire $3,000,000, cost of erecting its building. Petitioner has claimed, however, on its return for 1945, that it acquired the building in effect for the second time in 1945 and has claimed depreciation on this second cost. This latter amount of depreciation the Commissioner has disallowed and has confined his allowance for depreciation deduction petitioner's unrecovered cost of its building. Petitioner having fully recovered the cost of its building by way of depreciation deductions in 1945 and prior years had no unrecovered cost of its building.

We think that the bundle of rights which petitioner acquired by its contract of purchase of May 11, 1945, followed by the deed of June 11, 1945, was so inextricably entwined in the acquiring of the land as not to be separable therefrom. We think that no part of the $2,100,000 which petitioner paid can be allocated to the cost of the building which petitioner already owned and which it had been allowed to fully depreciate over the first 21-year term of the lease. The building and the lease were not bargained for or purchased separately. They were included, in so far as the lessor had any interest therein, in the single transaction of the contract [248] of purchase of the land and the deed to petitioner thereof. If petitioner were allowed additional depreciation deductions for the building which it claims in its second alternative, it would then have de-

preciated the building once since it has been erected and paid for by petitioner and a second time because it has purchased the land under the building. Petitioner cites no case which would support such a deduction and we know of none. Petitioner's second alternative is denied.

The only other issue which remains for our decision was stated in petitioner's brief as follows: "Is petitioner entitled to deduct that part of the $16,500.00 legal expenses incurred to acquire the fee and to cancel a burdensome lease?" The Commissioner in his disallowance of this deduction stated in his deficiency notice: "Deduction of legal expenses, in the amount of $16,500.00, incurred in connection with the acquisition of your property has been disallowed because it represents a capital expense." We think the Commissioner must be sustained in the disallowance of this claimed deduction. It was made to obtain capital assets and, as such, did not represent a deductible expense.

Reviewed by the Court.

Decision will be entered under Rule 50.

WITHEY, *J.*, concurs in the result.

[249] ARUNDELL, MURDOCK, OPPER, TIETJENS, RAUM and RICE, *JJ.*, dissenting. Some part of the purchase price should be allocated to the additional rights in the building acquired in the purchase, using the principle of *Cohan* v. *Commissioner*, 39 F. 2d 540, if necessary. This additional cost of the building would then be recovered through depreciation.

Decision.

[250]

THE TAX COURT OF THE UNITED STATES

WASHINGTON

Docket No. 36321

MILLINERY CENTER BUILDING CORP., (now Fashion Center Building Corp.),

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Pursuant to the Findings of Fact and Opinion of the Court promulgated February 26, 1954, the parties on March 22, 1954, having filed an agreed computation of the tax, now therefore, it is

ORDERED and DECIDED: that there is a deficiency in excess profits tax for the taxable year 1945 in the amount of $39,465.62.

(Signed) EUGENE BLACK

Judge

Enter:

Entered Mar 22 1954

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 127—OCTOBER TERM, 1954.

Argued March 15, 1955 — April 14, 1955

Docket No. 23150

MILLINERY CENTER BUILDING CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Before CLARK, Chief Judge; FRANK, Circuit Judge, and GALSTON, District Judge.

Petition to review a decision of the Tax Court of the United States. Eugene Black, Judge.

Petitioner, Millinery Center Building Corporation, seeks review of a decision, 21 T.C. 817, finding a deficiency in its excess profits tax for 1945, based on disallowance of deduction, depreciation, or amortization of sums expended in cancellation of a lease through acquisition of, and merger with, the underlying fee. Reversed and remanded.

Charles Korn, New York City (Bernard Weiss, New York City, on the brief), for petitioner.

Carolyn R. Just, Sp. Asst. to Atty. Gen., Washington, D. C. (H. Brian Holland, Asst. Atty. Gen., and Ellis N. Slack, A. F. Prescott, and Louise Foster, Sp. Assts. to Atty. Gen., Washington, D. C., on the brief), for respondent.

CLARK, Chief Judge.

This petition for review contests the finding of a deficiency in petitioner's excess-profits tax for 1945, based on the refusal to allow as a business expense the amount paid to terminate an allegedly burdensome lease. The issue concerns the tax consequences of a contract between the taxpayer and its landlord whereby the taxpayer acquired the real estate in question and thus obtained cancellation of the lease. The taxpayer as tenant and at its own cost had erected a 22-story loft building on the leased premises, to belong to the taxpayer only as long as the lease was in force and at termination to be either razed or surrendered to the landlord, as the latter might direct. The lease had been renewed by the tenant for an additional 21-year term just before the contract of sale was entered into, although the tenant now urges that the annual rental of $118,840 was excessive, notwithstanding the very substantial rents it was collecting, sufficient at least to make the renewal desirable. Petitioner's main argument throughout this litigation has been that the difference between the purchase price of $2,100,000 and the unimproved value of the land, $660,000, namely the sum of $1,440,000, should be deductible as an ordinary business expense under I.R.C. §23(a) as the price of cancellation of an onerous lease. Alternatively it suggested amortization of this amount over the unexpired term of the lease, or its depreciation as an additional cost of acquiring the already fully depreciated

building. All this the Tax Court denied, although six judges dissenting thought that some part of the purchase price should be allocated to the additional rights thus acquired in the building and then be recovered through depreciation. 21 T.C. 817.

The Tax Court refused to permit deduction under I.R.C. § 23(a) because it considered the $2,100,000 contract price as payment for one complete bundle of rights of land ownership, more appropriately characterized as a capital asset than as an ordinary business expense. With this conclusion we are in agreement, despite the contrary opinion of the Sixth Circuit in *Cleveland-Allerton Hotel* v. *C. I. R.*, 6 Cir., 166 F. 2d 805.[1] Whatever may be the case where a lease is cancelled without the purchase of a fee, we think that the situation here at hand consists of the acquisition of a definite and substantial property interest, so to be viewed for tax purposes. Petitioner, having certain rights in the property, bought all the remaining ones up to full ownership and is in the same situation as if it had bought out the share of a co-owner or an overriding easement or, indeed, a piece of land next door. Because petitioner also happened to be the tenant under the lease, its purchase resulted in the merger of the leasehold in the fee and gave it a good bargain. But that fact, while it may explain the motivation for the investment, cannot change its fundamental nature from the acquisition of a capital asset to mere removal of a burden or repair of plant. *Post* v. *C. I. R.*, 2 Cir., 109 F. 2d 135; *Herzberg* v. *Alexander*, D.C.W.D. Okla., 5 F. Supp. 334;

[1]This case is criticized in Notes, 48 Col. L. Rev. 967 and 1 Stan. L. Rev. 147. Both notes suggest that the court erred in considering the investment to be other than a capital asset. Both equally reject the solution of the Tax Court in that case and this one that no depreciation whatever be allowed, suggesting as an alternative amortization over the remaining term of the lease.

Boos v. *C. I. R.*, 30 B. T. A. 882; and see *Willcut* v. *Minnesota Tribune Co.*, 8 Cir., 103 F. 2d 947, 952, certiorari denied *Minnesota Tribune Co.* v. *Willcuts*, 308 U.S. 577. We reach this result whether or not the lease was in fact onerous to the taxpayer, as it contends; the Tax Court made no such finding and the evidence in this respect is doubtful at best. But that merely goes to the desirability or otherwise of the bargain; it does not define what was bought. We are equally in accord with the Tax Court that the purchase price of the fee is not to be amortized over the remaining term of the now nonexistent lease. Since the taxpayer has acquired the complete title to the property in question, it obviously no longer has a wasting asset to come to a necessary end twenty-one years hence. See *Post* v. *C. I. R.*, *supra*, 2 Cir., 109 F. 2d 135; *Friend* v. *C. I. R.*, 7 Cir., 119 F. 2d 959; certiorari denied 314 U. S. 673. But we do think the view of the dissenting judges sound that here is a new purchase price covering a building to be recovered taxwise, as is any building cost, over the period of its useful life.

The taxpayer's second alternative raised this issue in arguing that $1,440,000 be added for depreciation purposes to the cost of the building which it erected on the property. The cost of $3,000,000 originally invested by it in the building was fully written off during the first 21-year term of the lease. From this, a majority of the Tax Court concluded that no further depreciation was allowable, since the taxpayer's cost of acquisition had been recovered. But the dissent seems more in accord with the realities of this situation. The taxpayer in acquiring this fee bought not only a reversionary interest in the land itself, but also a reversionary interest in the building which under the lease it would have had to surrender to the landlord when its term expired. A third-party purchaser of such a fee would be entitled to allocate part of its cost to the building

and to depreciate it as such. Similarly, this taxpayer has made an additional investment in the building which should give rise to an added depreciation deduction in accordance with I. R. C. § 23(l).

On the present state of the record we cannot determine how much of the $2,100,000 purchase price is properly to be allocated to the land and how much to the building. The Tax Court has found only that in its unimproved state the land was worth $600,000. That appraisal cannot be considered as conclusive of its present value, improved by a $3,000,000 building appurtenant thereto. We doubt if a merely mechanical apportionment will adequately fix the intrinsic value of the building reversion. Hence we must remand this case to the Tax Court to take evidence, if desired, and otherwise to fix this value. See *Cohan* v. *C. I. R.*, 2 Cir., 39 F. 2d 540, 543, 544. A similar adjustment should be made with respect to the legal fees of $16,500 incurred by the taxpayer in connection with this purchase. The value so found will be the cost to be recovered through yearly depreciation.

Reversed and remanded for further proceedings in accordance with this opinion.

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 127—OCTOBER TERM, 1954

MILLINERY CENTER BUILDING CORPORATION, *Petitioner*, v. COMMISSIONER OF INTERNAL REVENUE, *Respondent*.	Docket No. 23150

PETITION FOR REHEARING

To the United States Court of Appeals for the Second Circuit and the Honorable Judges thereof.

The above named petitioner hereby respectfully petitions for a rehearing which the Court has inherent power to grant to prevent injustice, pursuant to Rule 25 of the Court's Rules and in support thereof shows:

The Court's opinion in this proceeding, filed April 14, 1955, holds (P. 1056-1057) that a payment made to obtain the cancellation of a lease at the same time the land is purchased is not an allowable deduction under Section 23(a) of the Internal Revenue Code of 1939. While this conclusion may be proper in many instances, such as in *Herzberg* v. *Alexander*, 5 F. Supp. 334 and *Boos* v. *Commissioner of Internal Revenue*, 30 B. T. A. 882, it is not applicable to the facts in this proceeding.

Petitioner claims that the opinion of the Court does not consider the argument upon which the petitioner places great reliance and which may not have been adequately stressed in the original argument before this Honorable Court.

The decision of this Court, denying the deduction of $1,440,000, was based on the theory that the taxpayer had paid $2,100,000 for a "complete bundle of rights of land ownership" and the situation was the same "as if it had bought out the share of a co-owner or an over-riding easement, or, indeed, a piece of land next door." Such conclusion failed to give consideration to a basic tax principle not sufficiently stressed in the argument advanced to the Court that payments must be considered in accordance with the purpose for which paid in determining the tax consequences to the taxpayer.

Thus, in *Western Wine & Liquor Co.* v. *Commissioner*, 18 T. C. 1090, a wholesale liquor dealer purchased some shares of American Distilling Co., which was offering its shareholders the right to purchase whiskey inventory at cost. After exercising these rights, the taxpayer sold the stock at a loss. The Tax Court, emphasizing that the taxpayer purchased the distilling stock not as an investment in stock but only to acquire more whiskey to replenish its inventories in order to sustain its business, held that the difference between the cost of the American Distilling stock and the selling price represented additional cost of the whiskey acquired. Certainly the vendor of the American Distilling stock to the taxpayer was selling his entire interest in the stock and all the rights that accrued therein but the Tax Court did not bottom its decision on such fact but on the intent of the vendee-taxpayer. This decision was appealed by the Government to the U. S. Court of Appeals, Eighth Circuit, but the appeal was dismissed. 205 F. 2d 420. See

also, *Chas. A. Clark*, 19 T. C. 48; *Bagley & Sewell*, 20 T. C. 983.

This Court itself has recognized that principle in *Helvering v. Community Bond & Mortgage Corporation*, 74 F. 2d 727, and in *Roscoe v. Commissioner*, 215 F. 2d 478. (Not previously cited to the Court). While the latter case is the contra to that of the Millinery Center Building Corporation, the principle is the same. In that case two stockholders sold all of their holdings in a real estate corporation with which the corporation had an exclusive contract to sell the realty subdivision. The amount received for the stock was in excess of the actual value. The sale contract was for a unitary amount for the stock but as part of the contract the taxpayers agreed to cancel their agreement of exclusive agency. This Court upheld the Tax Court in taxing as ordinary income that part of the selling price in excess of the value of the stock. This Court said whether the excess amount represented compensation for services or payment for cancellation of an undesirable contract, it would be ordinary income. The important point is that the Court looked through the form of a unit price to get to the substance and sustained an allocation between the amount received for the actual value of the asset being sold and for services or cancellation of a contract.

This principle of having the intent of the purchaser govern the taxability of the transaction as well as allocating a single purchase price to the purposes for the payment has also been recognized in tangible property and real estate transactions. Thus, in *Olympia Harbor Lumber Co. v. Commissioner*, 30 B. T. A. 114, the petitioner paid $7,900 to acquire certain equipment owned by the vendor with a value not in excess of $2,500, and with the purchase of said equipment a contract between the petitioner and the vendor

was automatically terminated though not specifically stated. The difference of $5,400 was considered to be paid to rid the purchaser of an unsatisfactory contract and the deduction was allowed.

Similarly there is a line of cases dealing with the acquisition of the stock of a company in order to acquire real estate and other assets wherein it has been held that although the stock was what was actually acquired, and all the rights inherent therein, the intent was to acquire the assets and the amount paid for the stock was allocated to the real estate and other assets. Under this category would be the leading cases of *Prairie Oil & Gas Co.*, v. *Motter*, 66 F. 2d 307; *Commissioner* v. *Ashland Oil & Refining Co.*, 99 F. 2d 588; certiorari denied, 306 U. S. 661; *Kopper Coal Co.*, 6 T. C. 1209.

Farm land or orchard land is often bought and sold with the crop thereon for a single amount but allocations have been recognized by the Commissioner and, where not, certainly by the Courts.

With regard to the principle of merger; the decision of *Laird Bell* v. *Carter H. Harrison*, 212 F. 2d 253, is applicable. In that case a trust remainderman purchased the life interest of his parents and amortized the cost of the life estates over the life expectancy of his parents. The Commissioner disallowed the deduction for amortization, contending there was a merger of the two estates, particularly in view of the fact that the plaintiff evidenced no intent to preserve the two interests separate and distinct, and that in view of this merger the capital invested could be recouped only at the time of sale or other disposition by way of being added to the cost basis of such property. The Court of Appeals (Seventh Circuit), sustaining the taxpayer, dismissed this argument of merger or "bundle of rights".

The decisions referred to by the Court, *Post* v. *Commissioner* 109 F. 2d 135; *Herzberg* v. *Alexander*, D. C. W. D. Okla. 5 F. Supp. 334; and *Boos* v. *Commissioner*, 30 B. T. A. 882, are not in point in that each pertains either to a taxpayer who was already a fee owner or a taxpayer who had acquired the lease interest as an investment; whereas in the instant proceeding the Millinery Center Building Corp. already owned the building, had a lease on the land, enjoyed the income therefrom and did not have to make any current payment to acquire an investment in the lease.

In *Post* v. *Commissioner*, *supra*, the taxpayer was the owner of the land, who at the same time had a leasehold interest arising from the tenant's destruction of an old building on his property in order to put up a new one. A few years later, the tenant's interest was sold on foreclosure sale to a new company, all of whose stock and securities were received by the landlord, the landlord transferring his fee property to the new corporation. Here the landlord had not paid any amount to anyone and the accounting item of leasehold was merely transferred to the new company in exchange for the stock. There was no actual loss to deduct.

In *Herzberg* v. *Alexander*, *supra*, the taxpayer had purchased an unexpired lease for 8 years and 9 months of an original 10-year lease from the tenant for $5,000. In the next year the taxpayer purchased the land and building from the owners for a consideration of $63,500. Where a taxpayer pays the lessee a sum of money to take over a lease, it is obvious that the lease is not onerous but favorable to the tenant and less favorable to the landlord. Then, the property sold subject to a lease not favorable to a landlord would probably command less than the actual value of the land and building and the addition of the lease payment to the property cost would tend to compensate for this fact and give the fair market value.

To illustrate: property is leased at $10,000 per annum for a period of 20-years but after 5 years the rental value of the property increases to $20,000 per annum. Because of the favorable low rent of $10,000 per annum, the tenant could sell his leasehold interest for $50,000. The landlord, however, subject to the low rent of $10,000 instead of the fair rental value of $20,000 finds that based on land values surrounding his property, his land should be worth $300,000, but he can only receive $200,000 because of the unfavorable lease. Now, if the new lessee, who has paid $50,000 to acquire the leasehold interest, purchases the land for $200,000, it would obviously be unjust and improper to allow him to write off that $50,000. That $50,000 is more properly added to the $200,000 purchase price to arrive at the actual value of the property purchased.

That is not the case in the instant proceeding where the tenant pays a sum of money to save paying excessive rent as well as being relieved from other onerous lease terms and where proof has been submitted that the actual value of the land is much less than $2,100,000.

In *Boos* v. *Commissioner*, *supra*, the taxpayer in 1927 acquired, at a cost of $25,000, a 99-year lease with option to purchase, and in the very next year exercised the option and acquired the remainder interest. The facts in Boos indicate that the entire transaction can be considered one continuing transaction, making the taxpayer's cost the initial $25,000 and the $55,000 paid in the next year. Furthermore, when a taxpayer pays $25,000 to acquire a lease, it cannot very well argue that the lease was onerous and that the purchase of the property was to effect the cancellation of the lease.

In answer to the obvious question, why did the Millinery Center Building Corporation renew the lease in April 1945,

it is respectfully submitted to the Court that the petitioner had a building thereon of substantial value, with a remaining economic life of 50-years and assessed in excess of $2,100,000, which investment it desired to retain.

This Court raised the question of whether the lease was in fact onerous, although such fact or lack thereof was not determinative of the Court's decision. Petitioner respectfully points out that the Tax Court did find that "petitioner purchased the fee to be released from the terms of the lease. Petitioner was most concerned about the annual rental of $118,840, which it deemed excessive, and the contingent liability to remove the building from the premises at the expiration of the lease upon the request of the landlord." (A 8)

There was also undisputed expert and authoritative testimony that the fair rental value of the land was between $35,000 and $40,000 per annum in 1945, although the petitioner was paying $118,840. (R. 149, 168, 170).

It is not necessary to lose money for a lease to be onerous. When one is paying 2½ times the fair rental value, that in itself affords a basis for the taxpayer to pay a sum to cancel such a contract. (See *The Stuart Co. v. Commissioner*, Tax Court Memo. Opinion Docket 12413. Aff'd 195 F. 2d 176).

The Post, Herzberg and Boos cases may be further distinguished from the instant proceeding in that the principle expressed therein pertaining to minor interests becoming merged with major interests is not applicable here. According to the testimony at the Tax Court trial, the fair rental value for the land alone on which the Millinery Center Building was erected was between $35,000 and $40,000 per annum compared to the $118,840 being paid. The excess of rent to be paid for the next 21-years would be

more than $1,600,000. To save this very substantial amount, and further substantial amounts in the event the lease was renewed, the taxpayer bought a piece of land worth $660,000. The purpose of this transaction was the saving of at least $1,600,000 in rent, and not the acquisition of a piece of land worth $660,000, which the taxpayer did not have to acquire in the first instance to enjoy the continued use of the premises. The purchase of the land was only incidental to and the only means by which the taxpayer could cancel an onerous lease and still retain its equity in the building which was productive of income. The transaction was not primarily to acquire land which only secondarily and incidentally resulted in the cancellation of the lease.

The result of this Court's opinion may be demonstrated in the following illustration. Assume a third party, desiring to make an investment, buys land and building for $2,100,000. The purchaser would make an allocation between land and building and depreciate the building over the period of useful life. Now suppose the building was erected by a tenant who has a leasehold running for 42 years. The purchaser would then be buying land and leasehold, which leasehold would be amortizable over the 42-year period, in accordance with decision of *Mary Young Moore* v. *Commissioner*, 207 F. 2d 265. Now, assume that the tenant of the leasehold wishes to do what the third party did and purchase the property for $2,100,000. Since he already has the lease he will not be acquiring a leasehold and since the lease is for a longer period of time than the life of the building, he may not be acquiring a reversionary interest in the building and therefore must be paying $2,100,000 for the land alone, even though the land is only worth $660,000. Following this argument further, the land, which is only worth $660,000 when an outsider buys it for an investment,

suddenly becomes worth $2,100,000 when the leasehold tenant acquires it.

This Court, in its opinion, inferred that the value to be attributed to the land might be more than the $600,000 found by the Tax Court for the land unimproved. This Court stated: "That appraisal cannot be considered as conclusive of its (land) present value, improved by a $3,000,000 building appurtenant thereto."

Petitioner respectfully points out that any value attributed to the land because of a building erected thereon makes the land a wasting asset, which is not contemplated by the Internal Revenue Code. There is no question that the building will eventually be of no economic value and therefore the land some day will be worth only the value of the land without any offsetting value for a building. To attribute an increased value to the land because of such a condition and not permit depreciation thereon means a taxpayer has a wasting asset, concurrent with the depreciation of the building which is not going to be recovered taxwise. This is contrary to every accounting principle and to the very meaning of Section 23(l) of the Internal Revenue Code of 1939 and the Regulations promulgated thereunder.

In *Commissioner* v. *Starr Brothers*, 204 F. 2d 673, this Court held that an amount received by a dealer from a drug manufacturer in exchange for releasing the manufacturer from its contract obligation not to sell other dealers was ordinary income and did not constitute the sale of a capital asset. The Court agreed the taxpayer's rights were undoubtedly property but held the *termination of a contract is not a sale or exchange*. The property rights were not transferred, they merely came to an end and vanished. This case applied to the Millinery Center Building Corporation proceeding makes the answer clear—there were no property rights acquired by the Millinery Center Building Corpora-

tion in the cancellation of the lease. Whatever property rights to the excessive rent existed were not transferred as if to a third party purchaser but "merely came to an end and vanished." There was no "bundle of rights" to the Millinery Center Building Corporation and the amount paid to secure such vanishment was an ordinary and necessary expense and an allowable deduction.

It is stressed before the Court that the deduction of $1,400,000 or any part thereof does not result in a net tax loss to the Treasury but only compensates in part for the additional tax that is going to be paid by the petitioner in each year for at least the next 21 years. The petitioner's returns for 1945 and ensuing years no longer reflect the deduction of rent expense of $118,840. Its land investment entitles it to a saving in rent from $35,000 to $40,000 per annum, but the balance of approximately $80,000 the taxpayer is saving because it incurred the expense of $1,440,000, and it is paying tax on such $80,000 each and every year without any offsetting deduction, and at the end of 30-years it will have a land asset of only $660,000. This is an unconscionable deprivation of capital of this taxpayer.

Petitioner therefore respectfully requests a rehearing upon these points at the Court's convenience. Should further oral argument be deemed impractical, petitioner requests that consideration be given to the points set forth herein.

Respectfully submitted,

BERNARD WEISS,
Counsel for Petitioner on Review,
136 East 57th Street,
New York 22, N. Y.

April , 1955.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 127—OCTOBER TERM, 1954

MILLINERY CENTER BUILDING CORPORATION, *Petitioner*, v. COMMISSIONER OF INTERNAL REVENUE, *Respondent*.	Docket No. 23150

CERTIFICATE OF COUNSEL

I, Bernard Weiss, do hereby certify that I am Counsel of Record for petitioner on review in the above entitled proceeding; that the foregoing petition for rehearing is presented in good faith and not for the purpose of delay or vexation, and that in my opinion it is well founded in law and fact and proper to be presented to the Court.

.....

BERNARD WEISS,
Counsel for Petitioner on Review

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

MILLINERY CENTER BUILDING CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Before CLARK, Chief Judge, FRANK, Circuit Judge, and GALSTON, District Judge.

On Petition for Rehearing.

Bernard Weiss, New York City,
for Petitioner on Review.

PER CURIAM.

Petition for rehearing denied.

C. E. C.
I. N. F.
U. S. C. JJ
C. G. G.
U. S. D. J.

Filed May 18, 1955

APPENDIX B

CLEVELAND ALLERTON HOTEL, INC. v. COMMISSIONER OF INTERNAL REVENUE

No. 10558

CIRCUIT COURT OF APPEALS, SIXTH CIRCUIT.

March 22, 1948

1. Internal Revenue—234

Generally, "capital assets" for income tax purposes, consist of property devoted to production of income and may consist of intangibles such as franchises, good will and the like.

2. Internal Revenue—121

Taxation is a practical matter and taxing authority may look through form to substance.

3. Internal Revenue—551, 574.

Where lessee owning and operating hotel building on leased premises purchased fee from lessor for a price greater than value of land in order to escape from a burdensome lease, lessee was entitled to deduct difference between price paid and amount which evidence established was value of the land, as an expense of doing business in the year when made, though no such separation of consideration was made in the purchase transaction.

Petition to Review a Decision of the Tax Court of the United States.

Petition by the Cleveland Allerton Hotel, Inc. to review a decision of the Tax Court redetermining deficiencies in income taxes assessed by the Commissioner of Internal Revenue.

Reversed and remanded.

M. R. Schlesinger, of Cleveland (M. R. Schlesinger, of Cleveland, on the brief; Horwitz, Kiefer & Harmel, of Cleveland, of counsel), for petitioner.

Louise Foster, of Washington (Theron L. Caudle, Sewall Key, George A. Stinson and Louise Foster, all of Washington, D. C., on the brief), for respondent.

Before HICKS, SIMONS and MILLER, Circuit Judges.

SIMONS, Circuit Judge.

The tax problem posed by the present appeal is one for the solution of which there is no precedent. It is clearly a case of first impression, and involves the question whether a lessee in possession, owning and operating a hotel building on leased premises, who purchases the fee from the lessor for a price greater than the value of the land, may allocate a portion of the purchase price to the purchase of the unexpired lease either by deducting the allocated portion as a business expense in the year of purchase or depreciate it over the term of the lease or the anticipated useful life of the hotel building. The Tax Court decided that the petitioner could do none of these things, and the taxpayer seeks review.

The case involves tax liability for 1941 and 1942. Deficiencies were asserted for such years by the respondent. In 1941, the petitioner was the owner of a 16-story brick and steel hotel in Cleveland, built upon leased ground. With details of its acquiring possession, we are not presently concerned. The lease had an unexpired term of 80 and a fraction years, and the ground rent was $25,000 a year. The petitioner concluded that its rent was excessive by at least $15,000 a year, and that ultimately it might lose its building, if it found no escape from the obligation. After

negotiating with the owners of the fee, it submitted a written offer to purchase the fee for the sum of $441,250 in cash, and the offer was accepted in writing by the owner of the land. On March 19, 1941 the purchase was consummated by payment of the money and the delivery to petitioner of the lessor's deed, which not only conveyed title to the real estate, but recited that the lease and the estate thereby created should merge in the title, the grantor acknowledging that all of the covenants, provisions, and conditions of the lease had been fully performed.

The petitioner in its tax returns for the tax years sought a deduction in substantial amount for part of the purchase price, on the ground that it was paid, not for the real estate but to be relieved of an improvident rental obligation, that consideration for the release could accurately be measured by the difference between the fair value of the real estate and what it was obliged to pay therefor, and that such amount was an expense of doing business. It here contends that the deduction was allowable in full in 1941, or in the alternative that it should be permitted to amortize it either over the term of the lease or the anticipated useful life of the building. The respondent contends that the deduction may not be granted in either form and the Tax Court agrees.

The petitioner argues that its primary purpose was to buy its way out of that portion of its leasehold obligation which was excessive and that its purchase of the fee was merely incidental to that purpose. It could not, it says, have merely secured escape from a burdensome lease and leave the premises because it owned a valuable building thereon. It had no need for the fee simple title because it already had full possession and use of the land by the provisions of the lease for its unexpired term. Uncontradicted testimony supports the petitioner's assertion of its pur-

pose and the necessity for buying the land to escape from the lease. Its claim that the value of the land was no more than $200,000 is supported by credible and uncontradicted evidence, which the Tax Court finds establishes that if there were no lease to be considered the value of the land would be $200,000. The petitioner concedes that neither in the negotiations to purchase nor in the contract which eventuated, was there any designation of consideration separately assignable to the purchase of the leasehold or to the reversionary interest in the land, but urges that such allocation has no bearing on the problem for if the transaction is to be viewed realistically, what it paid over and above the fair value of the real estate must necessarily have been paid to escape an excessive rental obligation. The respondent argues that the price of all land is almost wholly determined by the amount prospective purchasers will receive through its ownership and use, that the land in 1941, by reason of a very profitable lease, secured by the hotel building, was a capital asset, which either to the lessee or to other prospective purchasers would fully support the price that was paid for it. He reasoned that a prospective owner in April 1941, whether taxpayer or third party, would annually produce from the land $25,000, and that the capitalization of this return at an acceptable interest rate controls the value of the land. He also relies on the fact that there was no allocation of the purchase price separately to land or lease, so that there is no basis for the allowance of a deduction either by treating any part of it as 1941 expense, or by amortizing it over the term of the lease or the useful life of the hotel building.

(1) As purely legalistic formalism, this argumentation bears an aura of validity. Realistically considered, however, it will not stand analysis. The status of the petitioner does not approximate that of a third person investor,

buying real estate to which is appurtenant a long-term profitable lease. The petitioner already had the use of the land with full control and dominion over it, subject only to its obligation to surrender it at the end of the term. The lease was a liability which it sought to extinguish. This it was impossible to do merely by buying acquittance and giving up possession of the premises. It had thereupon a valuable hotel building which it could not take away with it. The only interest in the land it secured by the purchase that it did not already have was the reversionary interest, which all parties appear to consider as of only nominal value. To consider that remainder a capital asset with a value of $441,250 requires, it seems to us, a naivete not attributable to experienced and sophisticated taxing authority. The usual conception of capital assets is that of property devoted to the production of income. True, it may not always consist of concrete things, as for instance in the case of franchises, good will and the like, but funds expended by way of liquidated damages for release from contract do not ordinarily buy capital assets.

(2) If numerous admonitions that taxation is a practical matter, that taxing authority may look through form to substance, is not mere rhetoric where the taxpayer's interest is involved, and a working formula only when it is of advantage to the Treasury, it would seem to be clear that the petitioner paid all over $200,000 to escape from a burdensome lease, and should be able to write that off as an expense of doing business.

A second ground for the Tax Court decision was that it was unable from the facts of the case to allocate any portion of the purchase price of the land involved to release from the lease, and so was unable to find any basis for a depreciation deduction. But the Court had found it to be established that the land without the lease had a value of

$200,000. The rest we think would be simple arithmetic. In determining a base for depreciation of improved property purchased without allocation of consideration to buildings as distinguished from real estate, there has never been any difficulty in determining the value of the improvements, nor of the value of improvements as income to the lessor where a lease is subsequently cancelled or forfeited; nor of a base for obsolescence of leasehold interests, or of mineral rights not valued separately from the fee. Cf. Limericks, Inc., v. Commissioner, 5 Cir., 165 F. 2d 483.

(3.) While the petitioner's evidence may have suggested the view that it was entitled to deduct the whole purchase price, with interest in the reversion treated as negligible, it now seems perfectly clear that the petitioner's position is that only that part of the consideration which it paid for the deed over and above $200,000 should be allocated as an expense paid to escape its rental obligation under the lease. This being so, we find ourselves in accord with the decision of the Third Circuit in Cassatt v. Commissioner, 3 Cir., 137 F. 2d 745, and with the decision of the Board of Tax Appeals in Appeal of Denholm & McKay Co., 2 B. T. A. 444, that payments of this character must be deducted on the taxpayer's tax return as an expense of doing business in the year when made. The reason set forth in the Cassatt case is that such payment is not prepayment of rent to secure future tenure, but is in consideration of cancellation (or surrender) and so in the nature of damages to secure relief from unprofitable contracts. This being our view, it is unnecessary to consider the petitioner's alternative contention in respect to the amortization of its original rental obligation over the term of the lease or the anticipated useful life of the hotel building.

Reversed and remanded to the Tax Court for such further proceedings consistent herewith.